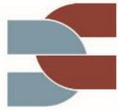

EUROPEAN ASSOCIATION OF CO-OPERATIVE BANKS

The Co-operative difference : Sustainability, Proximity, Governance

EACB Comments

EU Commission Targeted consultation on statutory prudential backstops addressing insufficient provisioning for newly originated loans that turn non-performing

Brussels, 27th November 2017

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Answers to specific questions

1. What are your views on the rationale for statutory prudential backstops as described above? In particular:
a. Do you support the idea that statutory prudential backstops should complement the improvements that the application of IFRS 9 is expected to bring with regards to loan loss provisioning for the new loans that turn non-performing?

- Yes
- No
- Don't know / no opinion / not relevant

Please explain the reasons for your answer to question 1.a:

We believe it is important that if a prudential backstop to address insufficient provisioning is to be established this is done on the basis of a well defined legislative proposal to be developed. However, we would like to point out that existing loans that have or will in the future turn non-perfoming are sufficiently covered by a number of existing instruments, e.g. the SREP dialogue and the SSM guidance on NPL management published in March, 2017.
Thus, we do not see a need to introduce an additional statutory prudential backstop regime as competent authorities in general and the ECB in particular already have sufficient tools at their disposal to identify banks with high levels of non-performing loans and recommend institution specific sound risk coverage.

Many provisions under current CRD IV (e.g. Art. 97(3), Art. 104(1)(d), Article 104(1)(a) of CRD IV) address the adequacy of processes, arrangements, and strategies in the institutions and the possible supervisory measures. Also, Art. 16(2)(d) of the SSM Regulation gives the ECB the power to prescribe a "specific provisioning policy or treatment of assets in terms of own funds requirements". And according to Art. 4(1)(f) of the SSM Regulation the ECB can impose further capital requirements if it finds a bank's arrangements, strategies, processes and mechanisms, together with its regulatory capital, to be insufficient to ensure sound risk coverage.
The peculiarity of all these tools is that they are institution specific, and designed in that manner.
In addition, if a prudential backstop were to be set it should be fixed in line with the expected shortfall estimation according to CRR Pillar 1 requirement, rather than adding new regulation.

Moreover, we have serious doubts regarding a one-size-fits-all approach, as while legacy assets constitute an issue for certain banks and particularly in some Member States, the new rules would have to be applied by all institutions in all Member States.
It should rather be left at supervisors to approach high NPL banks individually to discuss the issue and decide what action to take (e.g. via the SREP, as mentioned above).
Also, an additional prudential backstop regime for non-performing loans would be at odds with the principle of proportionality given that there are existing, proportionate means to achieve the intended results.

More in general, we would like to outline that high NPL ratios are not necessarily a problem per se if the bank has built up sufficient (accounting) provisions or has enough collateral. Comparatively high NPL ratios exist in retail banking, in particular, but banks negotiate

higher margins in this area to cover future defaults. It should be borne in mind that a restrictive squeeze would have effects on credit policies and may push out of the market customers that could turn to grey market or the shadow banking sector, which does not seem preferable.

Finally, high NPL ratios correlate with national economic conditions. New regulations/backstops would not solve the underlying problems nor would it address issues on timely accessibility of collateral, which requires reforms of the national legal system.

b. Do you support the idea that statutory prudential backstops (Pillar 1 measure) should complement the use of existing supervisory powers to address through institution-specific measures the (under)capitalisation of NPLs (Pillar 2 measure)?

- Yes
- No
- Don't know / no opinion / not relevant

Please explain the reasons for your answer to question 1.b:

Please also refer to previous answer.

Accounting and sound NPL management (i.e. governance and operations) are the key instruments for tackling NPLs. It would be more appropriate to ensure compliance with existing rules and appropriate monitoring and supervision, that allow timely action.

Should the European Commission nevertheless decide come forward with a proposal for a prudential backstop, at least the scope of eligible collateral should be extended. Limiting eligibility to collateral which meets the criteria set out in the CRR for credit risk mitigation purposes would be too restrictive. Other types of collateral should also be permitted for the purposes of the prudential backstop as long as the value of the collateral is calculated conservatively and it can be demonstrated that its validity is regularly checked.
At present, the only types of physical collateral considered eligible would be real estate and leased assets. For instance, it is still unclear whether and in which markets vehicles would be eligible as CRR collateral for the purposes of securing auto loans as the EBA has not issued a list of "other" physical collateral under Article 199(8) of the CRR which can be assumed to meet the conditions of Article 199(6)(a) and (b), namely liquid markets for the swift and economically efficient disposal of the collateral and well-established, publicly available market prices. Where instead, the EU has efficient and smoothly functioning used car markets, in which automobile prices are regularly set by agencies.

In addition, some application issues would further need to be clarified. If the reduction of own funds according to Art. 3 CRR is required, tax effects must be taken into account. This is because the additional deductible amount required by regulatory requirements would reduce the taxable base for income taxes, once it is actually realized in accounting.
Furthermore, we assume that the capital deduction under Art. 3 CRR is to be interpreted as "further reduction of own funds" within the meaning of Art. 159 CRR and may therefore be taken into account in the valuation allowance comparison. This should be clarified.

Overall, the implementation of an additional prudential backstop as proposed could lead to unjustified capital measures even to banks with sound frameworks and sufficient provisioning.

Finally, under Pillar 1 NPLs are already addressed. Art. 125 CRR provides that NPL exposures in SA are weighted with a higher RW of 150% to address higher credit risk. This reinforces the reasons for additional measures to be better suited under Pillar 2.

2. Do you think that the statutory prudential backstops as described above are feasible?
- Yes
- No
- Alternative designs of backstops via prudential deductions could be envisaged for new loans that turn non-performing
- Don't know / no opinion / not relevant

In general, a standardised timeline (e.g. 2/8 years) to fill the prudential provisioning is not suitable to cover the huge amount of different tenors.
Especially in situations where the tenor amounts to more than 10 years these fixed rules are not appropriate.
Additionally, experience shows that within the first 2 years of an ongoing restructuring of an exposure (retail and commercial as well) an expected amount to be repaid can be estimated. Thus, the proposed provision does not take into account the agreed repayment schedule, which can differ dramatically. It must also be taken into account that during a restructuring process normally no efforts are made to realise security, Therefore it cannot be assumed that the realisation of security was unsuccessfully attempted from the beginning.
Therefore, we believe that after the period of two years of vintage it should be assessed whether the customer is still unlikely to pay or has already become likely to pay. In the event that the customer is unlikely to pay the unsecured part of the exposure could be subject to prudential provisioning. Any provision forcing institutions to an automated prudential provisioning is considered as excessive and therefore should be avoided.

Overall the proposed backstops do not differentiate strategies across portfolios and towards clients. Moreover, for going concern cases of large customers that are still operating, the backstop might lead to the rejection of valid forbearance measures as implementation and probation period lead to an unwanted increase of the individual loan loss provisions (ILLP).

3. In your view, which should be the cut-off date for the origination of loans that will be covered by the prudential backstop?
- the date of publication of this consultative document
- the date of the publication of a possible legislative proposal introducing prudential backstops
- the date of entry into force of such possible legislative measure
- a later date of application?

If the backstop is introduced the timeline should be realistic and the cut-off date fixed at "a later date".

3.a. Would you see a need to address explicitly potential circumvention possibilities, for instance through prolongation of existing contracts? Please explain:

Possibilities such as prolongations are already part of existing forbearance rules in accounting and Pillar 2 frameworks. There would be no need to further elaborate on this.

The discussion concernig a cut-off-date can would however lead to circumvention possibilities. This is a further argument against a common prudential Pillar 1 measure. Appropriate treatment of NPLs in a prudential backstop has to be evaluated in individual Pillar 2 supervisory evaluation processes.
Nonetheless, it remains necessary and appropriate that a cut-off-date is established and a transitional phase for existing NPL provided.
Indeed banks should at least have sufficient time to back-test their current business model against any potential backstop. Any necessary adjustment of standard contract and product is time consuming, a backstop should not become operational before January 2019.

4. Do you think a full coverage of unsecured (parts of) NPLs after 2 years and of secured (parts of) NPLs after 6 to 8 years is appropriate?

- Yes
- No
- Don't know / no opinion / not relevant

Please explain the reasons for your answer to question 4:

Please also refer to previous answers. Such requirements are too rigid and deviations should be possible. It is clear that a bank should take action after a certain time (e.g. if it is foreseeable that collateral may become worthless). But if the bank can demonstrate cashflows (e.g. as a result of selling the collateral) at a later stage (e.g. by a letter from the insolvency administrator), longer realisation times should be accepted.

4.a. For secured (parts of) NPLs, do you think it appropriate to treat them as unsecured after 6 to 8 years, effectively adding two more years before full coverage?

- Yes
- No
- Don't know / no opinion / not relevant

Please explain the reasons for your answer to question 4.a:

Please refer to previous answer. In addition, this approach would be appropriate only where the starting date is the enforcement start date of the collateral rather than the default date.

4.b. For secured (parts of) NPLs, do you think an alternative approach, such as the introduction of specific levels of haircuts on collateral/guarantee values, would be more appropriate?

- Yes
- No
- Don't know / no opinion / not relevant

Please explain the reasons for your answer to question 4.b:

A deduction approach would limit the level of credit protection to guarantees and other collateral that are eligible within the CRR. However, there are numerous protection instruments which are not eligible, yet still have substantial economic value. Therefore, a haircut approach should be chosen but haircuts shall only be applied to collateral for which no qualified, up-to date valuation is available. Moreover, this approach would reveal inappropriate as collateral has to be re-evaluated on a yearly basis, which can result

already in a loss of value. Collateral validation procedures ensure that the haircut on the market value is adequate.
Finally, a methodological synchronisation through Pillar 2 approach is preferable to prevent inconsistencies.

4.c. If none of the approaches work in your view, how should the backstops be alternatively calibrated? Please explain the reasons for your answer.

The existing Pillar 2 instruments available to supervisors already work as backstops, in our view, and are sufficient to address the issue.

5. Do you agree that prudentially sound collateral valuation is an important element for addressing NPL-related risks?

- Yes
- No
- Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 5:

Yes, we believe that it is an important element.

5.a. In this context:

- would a common (non-binding) methodology for collateral valuation suffice to foster consistent outcomes and transparency?
- or would specific (binding) valuation rules be needed?

Please explain the reasons for your answer to question 5.a:

No additional guidance or rules are necessary. As already mentioned, it should be ensured that the existing rules are applied appropriately.

5.b. More generally, should specific prudent valuation requirements apply to assets and off-balance sheet items accounted for amortised cost as it is already the case for fair-valued assets?

- Yes
- No
- Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 5.b:

Please refer to previous answers.

6. Do you agree that prudential coverage needs should ultimately depend on the actual recoverability rather than the valuation of the collateral to provide for a backstop?

- Yes
- No
- Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 6:

Please refer to previous answers. Not only, the coverage also disregards current cash flow estimates from operations, which are an essential component for going concern situations.

7. Do you agree that the application of the statutory prudential backstops should not result in cliff-edge effects, but should rather be implemented in a suitably gradual or progressive way by banks from the moment of the classification of the exposure as non-performing?

- Yes
- No
- Don't know / no opinion / not relevant

Please explain the reasons for your answer to question 7:

Please refer to previous answers. We agree that cliff effects should be avoided, however, we would like to point out that a gradual build-up of backstop provisions would run counter to accounting rules (IFRS).

7.a. In particular, which approach (gradual or progressive) would you consider better suited and why?
Please explain the reasons for your answer:

The current accounting rules and accounting provisions should be the main elements of NPL coverage.

However, the "progressive approach" appears to be more appropriate to address the "wait and see approach". As for example collateral realization requires a certain period of time, it would be misleading to require significant provisioning or capital deduction, even for short term NPLs as this is not necessarily an indicator for "bad" NPL risk management.

8. Would you see any unintended consequences due to the design and calibration of the prudential backstops?

- Yes
- No
- Don't know / no opinion / not relevant

We would like to point out, that in the long run such proposals and rigid rules would lead to market failures and credit squeezes. Indeed, institutions will try to focus on borrowers of progressively higher quality, with many borrowers, including the vast majority of SMEs, that would find their access to credit significantly restricted. In addition, an overly strict quantitative measure could entail, that the unregulated shadow banking sector (hedge funds) would find themselves at a competitive advantage.
It would also be too restrictive to base the eligibility of collateral just on the CRR requirements. It would be important, to accept other types of physical collateral as long as their valuation was conservative and regularly validated. In addition, it should be clarified that other usually used collaterals, e.g. motor vehicles, fulfil the requirements of Article 199(6)(a) and (b) of the CRR with respect to liquid markets and general acceptable and publicly available market prices.